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SENSITIVE

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SUBJECT: SRI LANKA: ASSESSING IMPLICATIONS FOR U.S. BILATERAL
ASSISTANCE

REF: (A) STATE 134905
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¶1. (SBU) Summary: Post does not anticipate significant negative implications for U.S. assistance due to the financial crisis, particularly as the majority of assistance is centered in the East, which, with low levels of development, remains predominantly insulated from the crisis. However, post may experience some decline in available wholesale loan funds for on-lending (i.e., when the borrower agrees that loan proceeds will be made available to a third party) and a decline in available funds for public-private partnership program. Sri Lanka's growth will continue in 2009, despite the global economic crisis and the country's ongoing conflict. Analysts anticipate GDP growth of around 5%, while the government officially expects growth to reach a minimum of 6%. Although lower than in recent years, this growth level remains respectable for Sri Lanka's developing economy, which registered 6% growth in 2008 and 6.8% in 2007. Sri Lanka's overall macro-economic outlook is, unfortunately, declining. The government will face significant difficulty obtaining financing to meet its 2009 budget needs. End Summary.

Real Economy and
Trade and Investment Impacts

¶2. (U) Demand for key export commodities appears to be declining, as will earnings in key export sectors. Some industry experts forecast a 10-15% decline in 2009 apparel exports, Sri Lanka's largest export earner. On the other hand, Ajith Dias, the head of the Joint Apparel Association Forum (JAAF), is confident that industry earnings are more likely to remain at 2008 levels. Other key export industries, including tea, rubber, cinnamon, and tourism, will face difficulties reaching growth targets in 2009, as demand and prices for these industries declined in the second half of 2008. Remittances, a key foreign exchange earner for the government, remained stable through late 2008; nevertheless, they are also likely to slow in 2009. Some countries, such as South Korea, have frozen new migrant worker arrivals, and a decline in construction in countries such as the UAE will reduce demand for Sri Lankan expatriate workers.

¶3. (U) The government has taken action to curb imports by making them more expensive, recently raising import taxes on a range of import items. In October 2008, the Central Bank required importers

to keep a 100% deposit on letters of credit on a range of imports. Forward bookings of foreign exchange are permitted for a maximum period of 180 days for trade payments. In addition, from November 1, 2008, banks are required to obtain a 100% deposit of the contract value foreign exchange contracts in rupees.

¶4. (U) Sri Lanka's economy will, nevertheless, experience growth in ¶2009. Analysts anticipate growth of around 5% of GDP, while the government officially expects it to reach 6%. To ensure the latter, the government announced a stimulus plan on December 30 (ref b) aimed at assisting key export earners and the energy sector; it will likely not be enough, however, to ensure growth at desired levels.

Financial Sector Impacts

¶5. (SBU) Although Sri Lanka was largely insulated from the immediate effects of the global economic downturn, there are indications that firms are now finding it more difficult to borrow (ref d). Interlocutors report that some banks have closed their trade facilities. This is not just a result of the global financial crisis; local factors are also limiting access to financing. In early December, an interim Supreme Court order halted payments to several international and banks involved in hedge contracts with the government's Ceylon Petroleum Corporation (ref e). The government's ability to obtain financing is now severely restricted. Additionally, in late December, the Central Bank of Sri Lanka dissolved the Board of Directors of the private Seylan Bank and vested administrative powers in the hands of state-owned Bank of Ceylon. This was done to assure overall financial stability in the

market following mismanagement of an affiliated non-authorized financial institution, but the result is a more cautious outlook on bank operations by consumers.

¶6. (U) The government expects that interest rates will fall in 2009 with inflation, which ended 2008 at 14.4%, year-on-year, following a high of 28% in July 2008. Nevertheless, it is always expensive to borrow in the local market; interest rates for blue-chip companies average 18.5%, while rates for other companies are much higher. Although Sri Lanka's banking sector has remained quite resilient despite the global financial crisis, non-performing loan ratios increased from 5.2% in December 2007 to 6.5% in November 2008, suggesting growing credit risks.

¶7. (U) The government's attempt to raise $300 million through a syndicated loan in international markets in October 2008 failed, and in December an Indian bank withdrew plans to provide a $25 million loan to the GSL. Sri Lanka's credit rating declined recently, and S&P cut Sri Lanka's sovereign rating from B+ to B in December. Nevertheless, to date the GSL has never defaulted on loan payments.

¶8. (U) To date there has been little evidence of firms closing their doors; however, some, particularly those in the export sector, are looking to scale back hiring until they have a clearer picture of orders through end-2009. Others are working with staff to either amicably reduce wages or to encourage staff to voluntarily quit if provided a good severance package. (Note: Sri Lanka's labor laws make it extremely difficult to lay off or fire workers due to economic hardships; it is a long and costly process.)

Impacts on Government Revenues and Expenditures

¶9. (SBU) The government's new economic stimulus plan (ref b) reduces fuel costs for consumers while providing benefits to key export industries, including apparel, tea, rubber and cinnamon producers. The government plans to finance this stimulus package through reduced state expenditures and imposing cess on various imported items, including milk, wheat, and flour. However, realistically, the government will need significant additional expenditure cuts to adequately manage its 2009 budget and this new stimulus package. Contacts close to the President's chief economic advisor tell post that the government is discussing the possibility of a further Rs

16-20 billion stimulus package, which would provide additional relief to export industries.

¶10. (U) According to the official 2009 budget, government revenue is expected to increase by over 20% in 2009. Approximately 40% of government tax revenue and 35% of total government revenue comes from taxes on imports. Although the budget raised import taxes, due to falling import prices and a slowdown in imports, import tax yields may actually decline in 2009. This will cause further budget financing difficulties for the government.

Other Donor and Multilateral Institutions, Plans
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¶11. (U) Sri Lanka receives significant assistance from the World Bank, ADB, Japan, China, Iran and other donors. To date post is unaware of any major alterations in 2009 donor financing due to the global economic downturn. However, the government partially finances much of its infrastructure development through international organizations, and the lack of liquidity in the markets makes it very likely that the government will need to reduce its planned infrastructure development if unable to raise the necessary financing. The IMF echoed these concerns in late October 2008 when it cautioned that raising external financing will become increasingly challenging for Sri Lanka amid international risk aversion, further noting that Sri Lanka's external accounts are vulnerable to a reduction in international risk appetite.

Effects on U.S. Assistance

¶12. (SBU) Although not significant, post anticipates some negative effect on our bilateral assistance program. Sri Lanka has been mostly insulated from the immediate impact of the global financial crisis; nevertheless, Sri Lanka's economy will have to cope with the effects of the economic downturn due to the global nature of the

crisis and to the restricted availability of credit markets in the coming year. There will likely be two negative effects on USAID assistance programs. The first will be a lack of available wholesale loan funds for on-lending through USG small business loan guarantees. The second will be a decline in funds available from Sri Lankan partners for USAID public-private partnership projects that leverage funds from the private sector.

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